Testimony of
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New York Mercantile Exchange, Inc.
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Mr. Chairman and members of the Committee, my name is Jim Newsome and I am the President of the New York Mercantile Exchange (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products. We have been in the business for 135 years and are a federally chartered marketplace, fully regulated by the Commodity Futures Trading Commission. On behalf of the Exchange, its Board of Directors and shareholders, I thank you and the members of the Committee for the opportunity to participate in today's hearing on Hurricane Katrina's devastating effect on gasoline supply and prices.

First and foremost, we would like to acknowledge that not only has the nation's energy supply been severely affected, but lives have been lost, homes have been destroyed, and entire cities are in ruins. Our thoughts and prayers are with all the families that have suffered from the destruction of Katrina.

INTRODUCTION

NYMEX provides an important economic benefit to the public by facilitating competitive price discovery and hedging. As the benchmark for energy prices around the world, trading on NYMEX is transparent, open and competitive and heavily regulated. Contrary to some beliefs, NYMEX does not set prices for commodities trading on the exchange. NYMEX does not trade in the market and, being price neutral, does not influence price movement. NYMEX provides the forum for traders to come together and execute trades at prices which best represent what market participants think prices should be in the future, given today's information.

Periods of market uncertainty and volatility often result from extreme supply disruptions as we see with the numerous refineries shut down due to Hurricane Katrina, which brings me to the reason I was asked to testify today. There is a strong beneficial and interdependent relationship between the futures and cash markets. The primary motivation for using the futures market is to hedge against price risk in the cash market. Prudent business managers rely on the futures market to protect their business against price swings in the cash market. Price volatility following Hurricane Katrina drove many into the futures markets, as is reflected by the record volumes traded on NYMEX since the hurricane.

Futures markets provide a reference point for use in arranging trades at competitively determined prices. An understanding of the NYMEX market, its pricing mechanism and the relationship between the futures price and the cash price will provide useful instruction and clarity to what is often perceived as an esoteric area of financial dealings.

OVERVIEW

Futures markets fulfill two primary functions: (1) They permit hedging, giving market participants the ability to shift price risk to others who have inverse risk profiles or are willing to assume that risk for profit; and (2) They facilitate price discovery and market transparency. Transparency involves many factors, including: (1) Continuous price reporting during the trading session; (2) Daily reporting of trading volume and open interest; and (3) Monthly reporting of deliveries against the futures contract.

NYMEX futures contracts trade by open outcry on the Exchange floor during the day and during the evening on NYMEX ACCESS®, our after-hours electronic trading platform. Transactions are executed in a transparent and competitive environment between NYMEX members who are registered futures industry professionals. The daily settlement price for each contract is calculated pursuant to Exchange rules, which generally is the average price for all outright transactions during the closing range.

NYMEX energy futures markets are highly liquid and transparent, representing the views and expectations of a wide variety of participants from every sector of the energy marketplace. Customers from around the globe can call into a broker on the NYMEX trading floor to place buy and sell orders. On behalf of the customers, buyers announce their bids and sellers announce offers. The price agreed upon for sale of any futures contract trade is immediately transmitted to the Exchange's electronic price reporting system and to the news wires and information vendors who inform the world of accurate futures prices.

Price signals are the most efficient transmitters of economic information, telling us when supplies are short or in surplus, when demand is robust or wanting, or when we should take notice of longer-term trends. NYMEX futures markets are the messengers carrying this information from the energy industry to the public. The wide dissemination of futures prices generates competition in the establishment of current cash values for commodities.

GASOLINE

Gasoline is the largest single volume refined product by volume sold in the United States and accounts for almost half of national oil consumption. It is a highly diverse market, with hundreds of wholesale distributors and thousands of retail outlets, often making it subject to intense competition and price volatility.

NYMEX trades, among other things, New York Harbor leaded and unleaded regular gasoline futures contracts. The New York harbor gasoline futures contract trades in units of 42,000 gallons (1,000 barrels). It is based on delivery of petroleum products to terminals in the New York harbor, the major East Coast trading center for imports and domestic shipments, from refineries in the New York harbor area or from the Gulf Coast refining centers.

Average daily trading volume in these contracts has hit record levels in recent months and prices have been volatile. These market conditions reflect the basic market fundamentals where there is an imbalance of supply and demand. Tight gasoline supplies due to lack of refinery capacity, compounded by the impact of hurricane Katrina, which resulted in the closing of 9 refineries, has driven prices upward dramatically in the cash and futures market.

The importance of the Gulf Coast refineries as a key supply source for the New York Harbor via Colonial Pipeline directly impacts the physical gasoline market and the futures gasoline market. During the one-week period prior to hurricane Katrina, the cash market price for Gulf Coast gasoline averaged $1.82 per gallon (using the Platts wholesale assessment at the Colonial Pipeline), which was $.08 per gallon lower than the weekly average NYMEX futures settlement price. After the supply disruption due to hurricane Katrina, the Gulf Coast gasoline cash market rose more than one dollar to $2.84 per gallon for the daily average on August 30 (one day after the storm), $.37 higher than the NYMEX futures settlement price on August 30. This differential between the cash and futures prices represents the free market price that is derived in light of the extreme supply disruption and reflects a new equilibrium in the marketplace in response to the shock to the demand and supply balance.

NYMEX has closely monitored the gasoline futures market during this recent period of price increases in the aftermath of hurricane Katrina and has initially concluded that the market behaved rationally and the market participants acted responsibly in their futures and options trading.

SURVEILLANCE

Hurricane Katrina has had a devastating economic impact. Nine refineries in the Gulf of Mexico have been damaged beyond immediate repair and critical petroleum supplies have been lost. Prior to Hurricane Katrina, the U.S refineries had already been running at maximum capacity for years, struggling to keep up with rising gasoline demand. This huge natural disaster in a key refining region only further exacerbated an already growing problem.

The NYMEX Market Surveillance staff routinely follows trends in the cash markets, focusing on whether the futures markets are converging with the spot physical market as the NYMEX contract nears expiration. In light of the market uncertainties that resulted from hurricane Katrina, the NYMEX staff also monitored the supply and demand fundamentals in the underlying cash market to ensure that NYMEX prices reflect cash market price movements, that there are no price distortions and no market manipulation.

After analyzing events and developments over the past week, NYMEX staff believes that price increases experienced were due to fundamental market factors tied to supply disruptions in the wake of hurricane Katrina. The NYMEX system worked according to design, and added a level of economic stability to the situation by providing a viable price discovery and risk management forum.

SPECULATORS

It is widely, yet inaccurately, theorized that speculators can drive prices up. Placing blame on speculators may grab the attention of the media, but does not accurately reflect the realities of how markets work. With hundreds of commercial participants and instantaneous price dissemination, any "speculative" price would be met with an equally strong "commercial" reaction. If markets move in a direction inconsistent with actual market factors, there is a vast number of participants including energy producers, wholesalers, retailers, and government agencies that have comparable access to information. These participants will respond to ensure that prices rapidly return to where the industry consensus believes they should be.

Speculators do exist and they actually play a valuable, even necessary role in the market. They add liquidity to the market and enable commercial traders to get in and out of the market when necessary. By the nature of their role, speculative traders seek to take advantage of price trends, but because they lack the real product to back up their investment, they cannot control the price. They create virtually no impact on daily settlement prices, the primary benchmark used by the marketplace.

The Exchange has been scrutinized in the past on the role of hedge fund participation in causing market volatility. The effects of hurricane Katrina further emphasize the minimal impact hedge funds and speculators have on futures prices when compared to the real impacts of true market factors. hurricane Katrina is a natural disaster that severely disrupted the U.S. supply system and in effect drove prices higher.

Hedge funds do not account for anywhere near enough volume to affect prices. According to a NYMEX study on the participation of hedge funds in the energy markets over a one year period beginning in January 2004, hedge funds only accounted for 4.6% of overall futures volume. Of this total, the crude oil futures market had 3.07% hedge fund participation and, its products, heating oil and unleaded gasoline, had 3.62% and 3.26% hedge fund participation, respectively.

MARKET IMPACT OF KATRINA

NYMEX directly felt the disruptive effects of Katrina in our energy futures markets. The Exchange experienced several unprecedented market events in the aftermath of Katrina. Significant price moves occurred in the energy complex on Sunday evening during the NYMEX ACCESS® trading session which commenced at 7:00 PM. During this session (which is effectively the commencement of the Monday business day) gasoline moved upward due to severe concerns around the immediate and longer term effect to refineries in Louisiana, as well as pipeline distribution systems in the region.

During regular trading hours on Tuesday, August 30, the September 2005 unleaded gasoline contract traded to its maximum upward price limit, resulting in a temporary trading halt. Exchange rules impose a price fluctuation limit of $0.25 per gallon of unleaded gasoline above or below the previous day's settlement price. When that limit is hit, a five minute temporary trading halt is triggered. This limit was reached last Tuesday when the September 2005 contract traded at $2.31. In accordance with NYMEX Rules, the market was halted at 11:15 AM and re-opened after 5-minutes with an expanded limit of $0.50 cents above the previous day's settlement.

In response to the price volatility, NYMEX increased margins on several occasions for a variety of the energy futures contracts, including gasoline and crude oil. Margin is the money or collateral deposited with the clearinghouse to protect the clearinghouse against loss on open futures or options positions. In all cases, NYMEX required additional margin to maintain the integrity of the clearinghouse. Margin is vital to ensuring the financial integrity of the Exchange and provides the clearinghouse with the ability to protect customers against counterparty credit risk. On August 30, 2005, NYMEX managed and cleared the greatest single intra-day variation margin call scenario, when it moved nearly $2 Billion.

During the August 30 trading session, NYMEX set daily volume records for overall Exchange volume and for gasoline and crude oil futures, as well as for the Exchanges electronic clearing platform NYMEX Clearport^{sm}. The following day, August 31, Exchange-wide options, NYMEX Division options, and NYMEX ClearPort^{sm} clearing once again reached record volumes. These record volume numbers, clearly reflect NYMEX's importance as a transparent trading forum where customers can effectively manage their price risk. It is precisely during such times of market volatility and uncertainty that the Exchange's vital role in facilitating price discovery and risk management is most crucial to our customers.

During the entire week following hurricane Katrina, NYMEX Compliance and CFTC officials have had a heightened presence on the trading floor overseeing all markets. All activity has been thoroughly reviewed utilizing all available electronic tools to detect any abusive activities.

CONCLUSION

At all times during this period of extreme uncertainty in the market, NYMEX has been the source for transparent prices in the energy markets. Our price reporting systems to the world's vendors have worked flawlessly and without delay. Our trading systems during regular trading hours and during after hours trading on our electronic platforms have performed flawlessly.

Even though as consumers we may not like the result, the NYMEX marketplace performed its responsibility to create open, competitive and transparent energy pricing. We can only imagine the market uncertainty and further devastation to consumers if NYMEX were unable to perform its duty and prices were determined behind closed doors.

I thank you for the opportunity to share the viewpoint of the New York Mercantile Exchange with you today.